MEMORANDUM

TO: Chairman Richard L. Mathias
Commissioner Terry Harvill
Commissioner Edward Hurley
Commissioner Ruth K. Kretschmer
Commissioner Mary Frances Squires

FROM: Eve Moran and Phillip Casey, Administrative Law Judges
Assisted by: Dan Paulsen and Richard Shippee, Legal Externs

DATE: March 13, 2002

SUBJECT: Illinois Bell Telephone Company

Application for review of alternative regulation plan.

Illinois Bell Telephone Company

Petition to Rebalance Illinois Bell Telephone Company's Carrier Access and Network Access Line Rates.

Citizens Utility Board and The People of the State of Illinois
-vs-
Illinois Bell Telephone Company

Verified Complaint for a Reduction in Illinois Bell Telephone Company's Rates and Other Relief.

Re: Commission's deliberations in 98-0252/98-0335/00-0764 Consol.

DISCUSSION

Attached is a memorandum of law and fact, drafted in response to oral arguments heard by the Commission on January 28, 2002 in this proceeding. Its purpose is to assist the Commission in its deliberations with respect to the issues of: just and reasonable rates and rate reinitialization.

Given the length of this memo and the many items covered, we include a table of contents for the Commission's convenience.

I. Overview

In 1994, after many months of testimony, hearings, and arguments, the Commission adopted an alternative regulation plan for Ameritech Illinois (the Alt Reg Order" or "1994 Order"). Its Order, issued on October 11, 1994, implemented a system of price regulation for noncompetitive services as authorized under Section 13-506.1 of the Act, in place of traditional rate of return (ROR) regulation (for both competitive and noncompetitive services). Other possible forms of alternative regulation such as earnings sharing were not considered except as an additional feature to the price regulation plan.

The Appellate Court addressed challenges to the Commission's Alt Reg Order in its opinion in Illinois Bell Telephone Company v. Illinois Commerce Commission, 669 N.E. 2d 919 (2nd Dist. 1996) (parts of which were unpublished pursuant to Rule 23). Important to this case is the Court's rejection of a certain CUB argument and its determination that the goal of affordable telecommunications services does not require legislation that would prevent excess profits. Further, the Court recognized that the Commission's adherence to the guidelines set out in Section 13-506.1 would secure affordable rates.

The record for this review proceeding shows that the Plan worked well overall (although service quality was not entirely satisfactory) and demonstrates that among other benefits, noncompetitive service rates – the actual subject of the Plan - were reduced each year of its operation.

The record also contains suggested modifications for the Plan put forward by AI, Staff, and certain of the Intervenors, with each proposing different types of adjustments. Most significantly, there was the proposal of the Staff and the GCI/City to move "service quality" outside of the index. In addition, it became necessary to take account of, and respond to, recent legislative action that amended the Public Utilities Act.

In this first 5-year review of AI's alternative regulation plan, we gave parties wide latitude and the opportunity to put forward their respective theories of the case. The question of just and reasonable rates under the Plan (an element of Section 13.506.1) loomed large, and brought with it disputes over rate reinitialization and earnings sharing. There evolved two main theories, to wit:

> Staff and AI – took the position that prices for noncompetitive services (the clear and unmistakable focus of Section 13-506.1), were just and reasonable as per their respective showings and analyses.
>
> GCI/City – claimed that their earnings analysis (based on competitive and noncompetitive services earnings) showed that rates were not just and reasonable.

The CUB/AG complaint, consolidated into this proceeding, was ill-conceived in that it ignores the statute governing this case, i.e., Section 13-506.1. Whereas the statute- by its title and terms – speaks clearly and distinctly of noncompetitive service rates, the Complaint improperly sought to commingle earnings on those noncompetitive services with earnings on competitive services in order to push for further rate reductions outside the price index.

The HEPO for this proceeding issued on May 22, 2001, and thereafter, the General Assembly amended the PUA in several respects although Section 13-506.1 was reenacted unchanged. Public Act 92-22 (also referred to as House Bill 2900) went into effect on June 30, 2001. No party to this proceeding, however, wanted to reopen the record to address, with testimony any of the legal changes and corresponding effects on this matter. A new round of briefs on the recent statutory amendments, however, was determined to be appropriate by the ALJ's.

The General Assembly either modified existing language or adopted new provisions pertinent to this proceeding as follows:

1. Section 13-712, Basic local exchange Service Quality (new)

2. Section 13-518, Optional Services Packages (new)

3. Section 13-502, Classification of Services (amended)

4. Section 13-502.5 Services alleged to be improperly classified (new)

The final PEPO, served on all parties, issued on November 2, 2001. Oral arguments were heard on January 28, 2002. Based on the arguments presented to the Commission we believe that certain of the parties do not have a firm grasp as to the law or issues in the proceeding or the PEPO's resolution of same. At the same time, they have focused on irrelevant matters that may serve to prejudice the Commission's view. To the extent that we less than clear or shorthanded too much of our analyses, we submit the following details and points in support of our assessments and recommended order.

II. The Commission's Role

In oral arguments, the parties frequently refer to what they believe the Commission must do in this matter. As we see it, the Commission is only obligated to do the following:

(a) deliberate rationally on the basis of the competent, material and relevant evidence of record; distinguish between advocacy (not be swayed by emotional arguments) and record fact, and base its decision on a sound interpretation of controlling law.

(b) recognize that the law is what it is – not what someone wants it to be. Both by its very terms, and under Section 13-506.1, the Plan only relates to noncompetitive services. Hence, only noncompetitive service rates (and possibly the earnings thereon) are at issue.

(c) determine whether the Plan worked, and consider whether or what needs to be changed.

(d) if and only if the Plan has failed (a finding not supported by the record) may the Commission institute a "rescission action" to return the Company to ROR regulation.

(e) recognize that certain of the evidence relevant for one purpose might also be irrelevant and/or highly prejudicial for another purpose.

(f) consider a change to the reporting requirements so as to be consistent with the statute, i.e., Section 13.506.1 (d). The oral arguments make clear that reporting on facts and circumstances unrelated to the Plan's operations create misunderstandings and muddle the oversight process.

III. The Oral Argument Highlights

Most of the arguments heard by the Commission on January 28, 2002, focused on the issue of just and reasonable rates, the CUB/AG complaint, and the GCI/City proposal for rate reinitialization. We highlight only those arguments that are in opposition to the PEPO with respect to these particular matters. These are the Intervenor arguments.

According to the certain of the AG, CUB, Cook County arguments:

- The PEPO does not review whether the plan has fairly balanced shareholder and ratepayer interests or whether prices initially based on 10 year old data continues to be fair, just and reasonable. (Tr. 2340)

- An earnings analysis that considers <u>all</u> expenses, rate bases and revenues related to competitive and non-competitive services shows that combination of the price index and competition have not in fact been able to maintain fair, just, and reasonable rates. (Tr. 2346).

- The high returns on AI's "report to the Commission" demonstrate that the interests of shareholders and ratepayers have fallen way out of balance. Shareholders receive the lion's share of benefits resulting from cost savings, efficiencies, and reclassifications of services as competitive. (Tr. 2349).

- An analysis of the company's financial performance is what both Section 13-506.1 and the Alt Reg Order demand. (Tr. 2352).

- The company's position is that there is an "irrebuttable presumption" that rates under the Plan are justified and reasonable as long as those rates were established in accordance with the price cap formula, and the PEPO adopts this position. (Tr. 2353). The Appellate Court, however, ensures a petitioner's right to challenge the justness and reasonableness of rates by noting that the Commission may not create an irrebuttable presumption that rates are just and reasonable (citing to page 56 and 57 of the slip opinion – unpublished pursuant to Rule 23). (Tr. 2361)

- CUB and the AG have filed a complaint alleging that the Company's earnings are excessive and that a rate reinitialization is needed. (Tr. 2362). The GCI's expert concluded that a rate reduction of $956 million was in order to establish rates that approach a just and reasonable level on a going forward basis. (Tr. 2364).

- Insuring that the inputs in the price cap formula were applied and calculated correctly is exactly what is done in the annual finding. This docket requires more. (2355). Here, the Commission has a "legal duty to examine the Company's financial performance and make the necessary adjustments to ensure just and reasonable rates. (Tr. 2355)

  -Section 13-506.1 requires rates to be just and reasonable.
  -The record evidence shows high profit levels.
  -The Alt Reg order made reference to "earnings" as a barometer of how well the plan is functioning. (Tr. 2356).
  -The Alt Reg order requires the Company to file all of the financial information necessary for the Commission to evaluate its earnings each year. (Tr. 2357).

- Illinois law requires that the Commission balance ratepayer and shareholder interests. (Tr. 2354; 2358).

- An evaluation of earnings is the <u>only</u> valid measure of determining how well the plan functioned and whether rates will be just and reasonable on a going forward basis. (Tr. 2360).

- Contrary to the ALJ's interpretation of the Appellate Court's ruling, it affirmed the ability of the Commission to monitor earnings. For example, the Court never questioned the Commission's references to earnings as an evaluation of how well the plan was functioning. (Tr. 2361).

- Earnings have been tolerated under the plan that under ROR would have triggered a rate case. (Tr. 2375).

IV. The Law – Section 13-506.1 (220 ILCS 5/13-506.1)

It is undisputed that the provisions of Section 13-506.1 are controlling in this review and the Commission must act pursuant to its directives.

* This statute was the basis for, and directed the Commission's action in 1994 where it adopted the AI Plan.

* This statute authorized the Plan and governed this review proceeding when it began.

* This statute remains essential and governs the Commission's action by virtue of its reenactment unchanged by recent legislative action in effect as of June, 2001.

A court's primary purpose is to ascertain and follow the intentions of the General Assembly expressed in the statute. Graham v. Board of Ed., Com. H. S.D. No.77, 305 N.E. 2d 310 (5th Dist. 1973). The language used in a statute is the primary source for determining legislative intent; if the intent can be ascertained from the statutory provisions, such intent will prevail with resorting to other aids for construction; but where differing interpretations are proffered, legislative intent must be determined from reasons for the enactment and purposes to be attained thereby as well as meaning of words enlarged or restricted according to their real intent. Board of Trustees of Community College v. Taylor, 448 N.E. 2d 1171 (1st Dist. 1983) The specific meaning of words used in a statute is determined by considering the objective sought to be accomplished by the statute. Graham

Oral Argument Exhibits

At oral argument, CUB presented the Commission with a copy of Section 13-506.1, in part, but did not discuss all of the individual elements of the statute, or offer any interpretation of these provisions. Indeed, CUB only highlighted one line in one subsection and failed to provide a proper context for even that one element.

In many respects, the correct interpretation of the statute controls and settles the issues of the case. Hence, we here provide the Commission with the full text of Section 13-506.1 in bold type, and include after each subsection, our notes on statutory construction as well as the filing of the Appellate Court Illinois Bell Company v. Illinois Commerce Commission, 669 N.E. 2d 919 (2nd Dist .1996) ("Illinois Bell") in which it reviewed the 1994 Alt Reg. Order.

§ 13-506.1. Alternative forms of regulation for noncompetitive services.

By its very title, the General Assembly made clear that alternative forms of regulation only apply to noncompetitive services. This resolves any doubts as to the meaning of any subsections below. In construing a statute, every part, including its title, must be considered together. People v. Warren, 671 N.E. 2d 700 (1996). The official title of a statute can provide a court with essential guidance in interpreting its meaning. Chicago School Reform Bd. V. IELRB, 721 N.E.2d 676 (1st Dist. 1999)

See Illinois Bell: Section 13-506.1 was enacted to empower the Commission to adopt alternative forms of regulation for noncompetitive telecommunications services. (660 N.E.2d 923).

> **(a) Notwithstanding any of the ratemaking provisions of this Article or Article IX that are deemed to require rate of return regulation, the Commission may implement alternative forms of regulation in order to establish just and reasonable rates for noncompetitive telecommunications services including, but not limited to, price regulation, earnings sharing, rate moratoria, or a network modernization plan. The Commission is authorized to adopt different forms of regulation to fit the particular characteristics of different telecommunications carriers and their service areas.**
>
> **In addition to the public policy goals declared in Section 13-103, the Commission shall consider, in determining the appropriateness of any alternative form of regulation, whether it will:**
>
> > **(1) reduce regulatory delay and costs over time;**
> > **(2) encourage innovation in services;**
> > **(3) promote efficiency;**
> > **(4) facilitate the broad dissemination of technical improvements to all classes of ratepayers;**
> > **(5) enhance economic development of the State; and**
> > **(6) provide for fair, just, and reasonable rates. (Emphasis added)**

Plainly, this subsection (a) empowers the Commission to implement alternative regulation as a means by which to establish "just and reasonable" rates for noncompetitive services only. Such alternative regulation may take the form of, among other things, price regulation, or earnings sharing, or rate moratoria or a network modernization plan. See, In Interest of Lakita B., 697 N.E. 2d 830 (1st Dist. 1998)(Use of disjunctive term "or" between other terms in a statute gives rise to inference that

legislature intended that terms be viewed in the alternative). See also, Hedrick v. Bathon, 747 N.E.2d 917 (5th Dist. 2001). The statute recognizes earnings sharing as a stand-alone "form" of alt reg. – not as a component of a price plan. It is on the statute's list of possible, although not exclusive, forms of alternative regulation.

This subsection further gives the Commission the authority to adopt different forms of regulation in each individual instance based on the recognition that both telecommunications carriers and their respective service areas have different characteristics. In others words, a plan for carrier X be of a different type than the plan for carrier Z.

This subsection directs the Commission to consider both the 6 factors it specifies as well as the public policy goals set out in Section 13-103, when determining the appropriateness of a particular form of alternative regulation. In other words, the Commission must decide whether the particular form under consideration, is suitable for meeting the objectives outlined.

There is a proposal in the record for earnings sharing, but not as a new and different form of alternative regulation to be adopted in place of price cap regulation, i.e., the current plan. Instead, the proposal put forward by the GCI is to have earnings sharing be yet another "component" in the current plan.

Whatever the form of alternative regulation the Commission may be considering for a Company – it must assess the appropriateness in reference to the standards outlined in subsection (a) of Section 13-506.1. Thus, earnings sharing, viewed as either a stand-alone "form" of alt regulation o r as a "component" of the current plan, must still meet the objectives of the statute.

And consistent with Section 13-506.1 – only earnings on noncompetitive services can be shared. As such, in order to calculate earnings on non-competitive services, the Commission would have to devise a cost and revenue methodology along the lines of what Gebhardt attempted in his supplemental direct testimony, i.e., AI Ex. 1.1.

See Illinois Bell: Either a telecommunications carrier, or the Commission on its own motion, may initiate consideration of an alternative regulation plan. (669 N.E. 2d at 924). In determining the appropriateness of any alternative regulation plan, the Commission must consider both the public policy goals in Section 13-103 and the 6 factors [listed in this subsection] (Id.)

> **(b) A telecommunications carrier providing noncompetitive telecommunications services may petition the Commission to regulate the rates or charges of its noncompetitive services under an alternative form of regulation. The telecommunications carrier shall submit with its petition its plan for an alternative form of regulation. The Commission shall review and may**

> **modify or reject the carrier's proposed plan. The Commission also may initiate consideration of alternative forms of regulation for a telecommunications carrier on its own motion. The Commission may approve the plan or modified plan and authorize its implementation only if it finds, after notice and hearing, that the plan or modified plan at a minimum:**
>
> > **(1) is in the public interest;**
> > **(2) will produce fair, just, and reasonable rates for telecommunications services;**
> > **(3) responds to changes in technology and the structure of the telecommunications industry that are, in fact, occurring;**
> > **(4) constitutes a more appropriate form of regulation based on the Commission's overall consideration of the policy goals set forth in Section 13-103 and this Section;**
> > **(5) specifically identifies how ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change, and improvements in productivity due to technological change;**
> > **(6) will maintain the quality and availability of telecommunications services; and**
> > **(7) will not unduly or unreasonably prejudice or disadvantage any particular customer class, including telecommunications carriers. (Emphasis added)**

This subsection (b) begins with a general outline on how to proceed. Under its terms, only a telecommunications carrier that provides noncompetitive telecommunications services may bring a petition to the Commission. In doing so, it is required to submit its plan for an alternative form of regulation together with its petition. The Commission must review the proposal but it may modify or reject the carrier's recommended plan.

Under this subsection, the Commission also may, on its own motion, initiate consideration of an alternative form of regulation for a telecommunications carrier.

In both of these respects, after notice and a hearing, the Commission needs to find, at a minimum, that the plan or modified plan, meets with each of the 7 requirements set out in this subsection before it can give its approval to the plan or modified plan and authorize implementation. In other words, the alternative regulation plan, implemented in order to establish just and reasonable rates for noncompetitive

telecommunications services as per subsection (a) above, must be expressly found to, among other things, produce fair, just and reasonable rates.

While the word "approve" in a statute connotes exercise of discretion, judicial relief will lie in cases where the power to approve has been abused by unreasonable, arbitrary, or discriminatory action. Veterans Assistance Com'n of Will County v. County Board of Will County, 654 N.E.2d 219 (3rd Dist. 1995).

Witnesses are not legal experts and therefore, their opinions on law are generally improper and entitled to little or no weight. A statute does not say what someone thinks it says (or should say) if the interpretation put forward does not meet with recognized statutory construction principles that the courts follow. This is very likely one of the reasons that an agency ruling on law is not binding on a court. See Citizens Utility Board v. ICC, 651 N.E.2d 1089 (1995).

The record here contains a number of instances where a witness asserted his or her opinion on the law. For example, in Dr. Selwyn's view, the just and reasonable rate of return evaluation he proposes is to include all (competitive and noncompetitive) services. He arrives at this conclusion by noting that the particular language of Section 13-506.1 that requires (a) rates to be just and reasonable, and (b) ratepayers to benefit, is not by its terms limited solely to services that are classified as non-competitive. 220 ILCS 5/13-506.1 (b).

A reading of Section 13-506.1 in its entirety, however, shows Dr. Selwyn to be wrong. For all his other expertise, the witness is not an authority on the law. Indeed, his suggested interpretation flatly ignores Section 13-506.1 (a) which authorizes the implementation of alternative regulation in order to establish just and reasonable rates for "noncompetitive telecommunications services" and no other.

So too, the canon of statutory construction, known as ejusden generis holds that where general words follow specific words in a statutory enumeration, the general words are construed to embrace only objects similar in nature to those objects enumerated by the proceeding specific words. Sutherland, Statutory Construction, 6th Edition, Sec. 47:17 at 272 (2000 revision). The rule essentially accomplishes the purpose of giving effect to both the "particular" and the "general" words in a statute, by treating the particular words as indicating the class, and the general words as extending the provisions of the statute to everything embraced in that class, though not specifically named by the particular words. (Id. at 285). This is justified on grounds that had the legislature intended the words to be used in their unrestricted sense, it would have made no mention of the particular words. (Id at 286.).

In these premises, this means that the requirements of Section 13-506.1 as set out in subsection (b) must be construed in reference to noncompetitive services only. This is as the General Assembly intended.

See Illinois Bell: The Commission may implement a plan only if it finds, after notice and hearing that the plan or modified plan, at a minimum, meets the seven requirements of this subsection. (669 N.E. 2d 924).

> **(c) An alternative regulation plan approved under this Section shall provide, as a condition for Commission approval of the plan, that for the first 3 years the plan is in effect, basic residence service rates shall be no higher than those rates in effect 180 days before the filing of the plan. This provision shall not be used as a justification or rationale for an increase in basic service rates for any other customer class. For purposes of this Section, "basic residence service rates" shall mean monthly recurring charges for the telecommunications carrier's lowest priced primary residence network access lines, along with any associated untimed or flat rate local usage charges. Nothing in this subsection (c) shall preclude the Commission from approving an alternative regulation plan that results in rate reductions provided all the requirements of subsection (b) are satisfied by the plan. (Emphasis added)**

See Illinois Bell: The legislature incorporated certain safeguards in Section 13-506.1 including the requirement that, in the first three years of the Plan, the basic service rates be no higher than the rates in effect 180 days before the filing of the Plan. (669 N.E. 2d at 924)

None of the above directives prevent the Commission from approving an alternative regulation plan that results in rate reductions if all of the 7 requirements of subsection (b) are met in the process. (e.g., the reduction will not reduce the carrier's ability to maintain the quality and availability of service i.e., Requirement No. 6; or, the reduction will not unduly or unreasonably prejudice any particular class, including telecommunications carriers, i.e., Requirement No. 7) The Alt Reg Order reduced rates at the Plan's inception in 1994 and rates have declined each year thereafter. There is no evidence, however, that such reductions impacted adversely on the seven requirements of this subsection.

> **(d) Any alternative form of regulation granted for a multi-year period under this Section shall provide for annual or more frequent reporting to the Commission to document that the requirements of the plan are being properly implemented. (Emphasis added)**

See Illinois Bell: Another safeguard, that the Court noted, is the statutory provision "requiring at least annual reports documenting the telecommunications carrier is complying with the plan." (669 N.E. 2d at 924).

This subsection (d) expresses the intent that the operations of the Plan, be monitored by the Commission. It sets out an implicit directive for the carrier to sufficiently document each of the matters relevant to the Plan's workings. It does not, however, require or even suggest any reporting relative to earnings of any kind. Arguably, such reporting on earnings would fall within the statute if the form of alternative regulation to be implemented, was to be an earnings sharing plan.

> **(e) Upon petition by the telecommunications carrier or any other person or upon its own motion, the Commission may rescind its approval of an alternative form of regulation if, after notice and hearing, it finds that the conditions set forth in subsection (b) of this Section can no longer be satisfied. Any person may file a complaint alleging that the rates charged by a telecommunications carrier under an alternative form of regulation are unfair, unjust, unreasonable, unduly discriminatory, or are otherwise not consistent with the requirements of this Article; provided, that the complainant shall bear the burden of proving the allegations in the complaint. (Emphasis added).**

See Illinois Bell: Still another safeguard identified by the Court is the statutory language "providing for the rescission of a plan on the motion of any person alleging that rates under the plan are unfair, unjust, unreasonable, unduly discriminatory or are otherwise not consistent with the requirements of this article." (669 N.E. 2d at 919).

In our view, this subsection (e) speaks to three distinct processes:

1. Rescission by carrier petition

According to subsection (e), a telecommunications carrier may itself petition the Commission to rescind its approval of a Plan. So too, a petition for rescission may also be brought by any party.

2. Rescission by Commission initiative

On its own motion, the Commission also may rescind its approval after notice and hearing, if it finds that the 7 requirements set out in subsection (b) can no longer be satisfied. This, however, contemplates a separate action – See Quantum Pipeline v. Illinois Commerce Commission, 709 N.E.2d 950 (3rd Dist. 1999). (When exercising its power to rescind, the Commission is required to provide notice by means of a written complaint setting forth an alleged violation of the Act, order or rule of the Commission, and setting a time and place for the hearing thereon).

3. Complaints by any person

Any person is entitled to bring a complaint to the Commission wherein it is alleged that:

(a) the rates charged by a telecommunications carrier under an alt reg plan, i.e., rates for noncompetitive services, are unfair, unjust, unreasonable or unduly discriminatory; or,

(b) the noncompetitive service rates are otherwise not consistent with the requirements of this Article (XIII).

The complainant, however, bears the burden of proof on the allegations of the complaint in such instances.

Note: It would be superfluous for the legislature to have put in these Plan rescission complaint provisions if they did not exclusively pertain to noncompetitive rates.

> **(f) Nothing in this Section shall be construed to authorize the Commission to render Sections 9-241, 9-250, and 13-505.2 inapplicable to noncompetitive services. (Emphasis added).**

See Illinois Bell: The Court views this provision as "ensuring that preexisting safeguards against discriminatory or unjust rates are not subject to implied repeal." (669 N.E.2d at 919).

The provisions of Section 9-241 (Discrimination; prohibition), Section 9-250 (Rates, charges or regulations found to be unjust redetermination by Commission), and Section 13-505.2 (Nondiscrimination in the provision of noncompetitive services) are applicable to noncompetitive services and the Commission cannot determine otherwise based on anything found in this Section 13-506.1.

Note: The full text of these statutes is included in Appendix A to this memo.

V. The Appellate Court Review – Illinois Bell Telephone Company v. Illinois Commerce Commission, 669 N.E. 2d 919 (2nd Dist. 1996).

In addition to statutory law, there is also relevant case law that the Commission needs to consider. There is far more to the Appellate Court's review of the Alt Order than was argued by the Intervenors.

To be sure, a part of the PEPO's analyses addressing the reinitialization proposal relies on the Appellate Court's opinion that was issued on review of the Commission's Alt Reg Order. The pronouncements of the Court show that it considered both the basic elements as well as the entirety of Section 13-506.1. in resolving certain of the issues. It

further addressed, as a legal matter, one of the prominent contentions being resurrected in this proceeding. We here quote the most relevant portions of the opinion for present purposes.

The Published Opinion

Early on, the Court identified certain of the issues raised by CUB:

> *CUB contends (1) the Commission failed to incorporate an adequate price index or earnings sharing provision into the order; (2) the order permits Bell to earn monopoly profits in violation of section 13--506.1 which requires rates to be "just and reasonable"; (3) if section 13--506.1 allows the Commission to promulgate a regulatory scheme permitting monopoly profits, such legislation is beyond the State's police powers and is therefore void and unconstitutional; (4) section 13--506.1 represents an impermissibly vague and illegal delegation of authority by the legislature. (669 N.E.2d at 922). (Emphasis added).*

In its factual review discussing the Company's proposed plan, the Court observed that:

> *The price-cap plan would not provide for either the regulation or monitoring of Bell's earnings. Bell would have the authority--limited only by the price-cap index--to manage its business. Put simply, the price-cap index assumes the function of general rate proceedings. As part of price-cap regulation Bell would be allowed to set its own depreciation rates. Within this framework Bell and its shareholders would bear both the benefits and risks common to businesses that are not guaranteed a particular return on investment. (669 N.E.2d 925 (Emphasis added).)*

Thereafter, the Court proceeded to examine CUB's initial contentions, to wit:

> *CUB asserts that, if section 13--506.1 authorizes the promulgation of a regulatory scheme permitting monopoly profits, such legislation is void and unconstitutional as beyond the State's police powers. (669 N.E. 2d at 929).(Emphasis added).*

In addressing this argument, the Court wrote:

> *The legislature has expressly found that "affordable telecommunications services are essential to the health, welfare and prosperity of all Illinois citizens" (220 ILCS 5/13-102(a) (West 1994)) and that competition should be used as a substitute for traditional regulation when consistent with protecting consumers (220 ILCS 5/13--103(b)). Implicit in the former finding is that the absence of affordable telecommunications services would be detrimental to the public health, welfare, and prosperity. Having identified this problem and enacted section 13--506.1 as part of a comprehensive scheme to address the problem, the legislation is presumed to be a valid exercise of the police power. (669 NE 2d at 930) (Emphasis added) (cities omitted)*

So too, the Court identified another of CUB's positions:

> *CUB asserts, without support, that the original purpose of the Act was to protect "the public from public utilities charging rates that produce excess profits." CUB argues that section 13--506.1 "subverts" this original purpose. (669 N.E. 2d at 930) (cites omitted; emphasis added)*

The Court disposed of this challenge as follows:

> *Assuming arguendo that CUB is correct about the purpose of the Act and its "subversion" by section 13--506.1, this does not render section 13--506.1 beyond the State's police power. The police power provides the authority to legislate for the public good; it does not specifically define the public good or the manner in which the legislature should act pursuant to its police power. The police power, therefore, does not mandate legislation to prevent excess profits. Even if the Act's original purpose were to prevent excess profits, this would not require all subsequent regulation of public utilities to share this purpose. Therefore, even if section 13-506.1 were an abandonment of the alleged purpose of the Act, that abandonment would not violate the police power.*
>
> *Section 13--506.1 addresses valid public concerns in a reasonable manner. The legislature has identified a valid public health, morals, safety, or welfare concern. Section 13--506.1 directly addresses the question of affordability by requiring any rates set to be "fair, just, and reasonable." See 220 ILCS 5/13--506.1(b)(2) (West 1994). Additionally, for any implemented alternative regulatory plan the Commission*

> *must (1) identify how ratepayers will benefit (see 220 ILCS 5/13--506.1(b)(5) (West 1994)); (2) ensure that the quality and availability of telecommunications services do not degrade (see 220 ILCS 5/13--506.1(b)(6) (West 1994)); and (3) ensure that no customer class will be "unduly or unreasonably" prejudiced or disadvantaged (see 220 ILCS 5/13 -506.1(b)(7) (West 1994)). The foregoing provisions demonstrate that section 13--506.1 bears a more than reasonable relationship to the goal of maintaining affordable telecommunications services.(669 N.E.2d at 930) (Emphasis added).*
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> ***
>
> *In the present case, the legislature has carefully adapted and tailored section 13--506.1 to secure affordable telecommunications services by using competitive mechanisms in place of ROR regulation. This has been done in a manner that … attempts to avoid collateral effects unrelated to the legislative objective. We hold that section 13-506.1 is a permissible use of the police power. (Id) (Emphasis added) (cities omitted)*

The Court outlined yet another argument:

> *Additionally, CUB argues that section 13--506.1 is an impermissibly vague delegation of authority by the legislature. A legislative delegation of discretionary authority is void if the underlying statute does not provide intelligible standards to guide the agency in the exercise of the authority. (669 N.E. 2d at 930-931) (cites omitted).*

The Court responded to this argument as well:

> *We hold that the standards set forth in section 13--506.1 are sufficiently precise to pass constitutional muster. The Act requires the Commission consider both the public policy goals of section 13--103 (see 220 ILCS 5/13--103)) and the goals set forth in section 13--506.1(a) (see 220 ILCS 5/13 --506.1(a)(1) through (a)(6)). Additionally, section 13--506.1prohibits the Commission from approving and implementing any plan that does not, at a minimum, fulfill seven specific criteria. See 220 ILCS 5/13--506.1(b)(1) through (b)(7)). Finally, any plan adopted must maintain basic residential service rates for three years at the level in effect 180 days before the filing of the plan. See 220 ILCS 5/13--506.1(c). We consider section 13--506.1(c) to be a safeguard against any plan promulgated in violation of the*

> *standards created by the legislature. The minimum three-year moratorium on rate increases ensures that the legislature has the time to amend or rescind any Commission action taken pursuant to section 13--506.1. This protects against any errors the Commission may make in applying section 13--506.1's standards. (669 N.E. 2d at 931).*

The Unpublished Sections

In its direct review, the Appellate Court addressed a variety of issues raised with respect to the Commission's Order although certain portions of its opinion were unpublished pursuant to Rule 23 and are not to be found in the Reporters. In that part of its opinion, "nonpublishable under Supreme Court Rule 23," the Court noted that:

> The (Alt Reg) order does provide that rates filed under the plan 'shall enjoy a presumption that they are just and reasonable, and absent special circumstances, shall become effective without suspension or investigation under [a]rticle 9 of the Act.' We read this language as merely cautioning parties contemplating a rate challenge that the Commission will dispose of frivolous complaints in a summary manner. (Slip Opinion at 56-57).

To be sure, the Court found no fault as per its interpretation of the Commission's Order, which it did not view to constitute an irrebuttable presumption. (See Part VII of this memo).

Oral Arguments

The PEPO discusses the Court's opinion at pages 149-151. It is important for present purposes, however, that we point out what the Court did not decide.

On oral arguments, CUB maintained that the Court never questioned the Commission's references to earnings as an evaluation of how well the Plan was functioning. This assertion is simply a red herring. A plain reading of the Court's opinion shows that this particular language was never put into issue for review. Thus, the Court had no reason to address, in any way, this particular part of the Order. Other discussion and findings in the Court's opinion as set out above , however, shed important light on such matter, (See 669 NE 2d at 925.)

VI. Reenactment of Section 13-506.1 (Unchanged)

It is equally important to consider what the General Assembly did or did not do in recent times. Notably, both GCI witness Terkeurst and the Appellate Court have referenced the General Assembly's oversight of alternative regulation and the instant Plan for AI.

In discussing the extent of the regulatory compact inherent in a Plan, Ms. Terkeurst maintained that one would anticipate legislative action rectifying the situation if a regulatory commission allowed excessive earning levels to continue unchecked. (GCI Ex. 1.0)

In its review of the Alt Reg Order, wherein the Court established earnings to not be viable in the determination of just and reasonable rates, it also indicated that the statutory 3-year moratorium on rate increases gave the legislature time to amend or rescind any Commission action taken pursuant to Section 13-506.1.

Notably, the General Assembly took action on the PUA in June, 2001. It did not, however, amend the provisions of Section 13-506.1. Presumably, however, it was aware of the Appellate Court's opinion on review of the Alt Reg Order and the activity in this proceeding (including the HEPO that issued on May 22, 2001).

VII. Just and Reasonable Rates Under the Plan

The findings of the Commission must be supported by "substantial evidence" based on the entire record of evidence presented to or before the Commission both for and against such order or decision. 220 ILCS 5/10-201 (e) (iv). "Substantial evidence" has been defined as more than a scintilla, although it may be something less than a preponderance of the evidence and is such as a reasoning mind would accept as sufficient to support a particular conclusion. CUB v. ICC, 683 N.E.2d 938 (1st Dist. 1997).

Inherent in the legal standard of substantial evidence is the underlying requirement of competent, relevant and material proof presented for the Commission's consideration to either establish or rebut a particular proposition or issue. One such issue in this proceeding, arising from the requirements of Section 13-506.1, is the question of just and reasonable rates.

A. Presumptions and Inferences

In oral argument, CUB challenged what it perceives to be the Company's attempt to establish an "irrebuttable presumption" that rates under the Plan are just and reasonable. (Tr. 2353). In so doing, CUB misapprehends both the testimony of the record and the fundamental difference between permissive and mandatory presumptions. It also fails to comprehend the nature of the Court's pronouncement in the unpublished portion of its opinion reviewing the Alt Reg order.

Presumptions (and inferences) play a crucial role in the resolution of factual questions and are considered a staple of the adversarial fact-finding process. State v. Watts, 692 N.E. 2d 315, 321 (1998). Simply put, presumptions are legal devices that either permit or require a fact finder to accept the existence of one fact (the presumed fact) upon the proof of the existence of other facts (the basic, or predicate, facts). Watts, 692 N.E. 2d at 320. Presumptions are never indulged in against established facts, but only to supply the place of facts. Franciscan Sisters Health Care Corp. v. Dean, 448 N.E. 2d 872 (1983). Put another way, presumptions of fact are created to assist in certain circumstances where direct proof of a matter is for one reason or another rendered difficult. Panduit Corp. v. All States Plastic Mfg. Co., 744 F2d 1564 (7th Cir. 1984).

Illinois courts recognize two general categories of presumptions: permissive and mandatory. Id. A "permissive" presumptions – also termed an inference – is one that merely permits, but *does not require*, a fact finder to take as established the existence of the presumed fact upon the proof of the existence of the basic facts without placing any burden on the respondent. Id. In other words, the fact finder is "free to accept or reject the suggested presumption." People v. Hester, 544 N.E. 2d 797 (1989). A presumption of fact essentially establishes a prima facie case as to the issue involved and shifts the burden of producing evidence, but not the burden of persuasion. Smith v. Tri-R Vending, 619 NE2d 172. Prima facie generally means "at first sight" or "so far as can be judged from the first disclosure" or "presumably" or "without more." Matter of Severson's Estate, 437 N.E. 2d 430 (2nd Dist. 1982).

Conversely, a "mandatory" presumption *requires* a fact finder to take as established the existence of the presumed fact upon proof of the existence of the basic facts unless, and until, the basic or presumed facts are rebutted. Watts, 692 N.E. 2d at 320. The so-called "irrebuttable" presumption is a mandatory presumption that cannot be rebutted by evidence. Id. In other words, an irrebuttable presumption is conclusive: once the party proffering the presumption proves the basic facts, the adverse party is "not allowed to attempt to rebut the connection between the proven and presumed facts." Id. Thus, an irrebuttable presumption is not really a presumption at all, but a rule of substantive law. M. Graham, Cleary & Graham's Handbook of Illinois Evidence § 302.3. It is precisely this type of an irrebuttable presumption that the Court concluded could not be adopted by the Commission and which it did not believe that the Commission had sought to establish. See, Illinois Bell Telephone Company v. Illinois Commerce Commission, Slip Opinion at 56-57 (unpublished pursuant to Rule 23)("…the Commission may not create an irrebuttable presumption that rates are reasonable and just.").

1. The Respective Propositions of AI and Staff

CUB's challenge was apparently directed to the record evidence where AI witness Gebhardt testified that:

> In 1994, the Commission set going in rate levels that were "just and reasonable" under the regulatory paradigm and then established a price index plan that would maintain "just and reasonable" rates for the future. As long as the Company properly implemented the Plan and no major errors in specifying the individual components of the index were made, it can be presumed that the noncompetitive rates are just and reasonable. (AI Ex. 1.1 at 70)

When Gebhardt used the phrase "can be presumed" he was establishing a proposition upon which a reasonable inference *could* be drawn from the facts, but which was certainly open to be contradicted or rebutted by other evidence. This was not, as CUB would term it, an "irrebuttable" presumption.

The proposition thus set out by AI stems from the establishment of basic facts, as follows:

1. the Commission's 1994 Alt Reg Order established just and reasonable rates at the very start of the plan;

2. the Commission adopted the price index to maintain just and reasonable rates for noncompetitive services going forward;
3. the components of the price index were properly specified in 1994;

Presumed or inferred fact: noncompetitive rates are just and reasonable.

Staff itself set out a simpler but similar proposition on record, to wit:

1. rates were set at just, reasonable, and affordable levels in 1994.

2. thereafter rates declined – notwithstanding modest levels of inflation

Presumed or inferred fact: noncompetitive rates are now, a fortiori, just, reasonable, and affordable.

On the basis of their respective propositions and showings, these proponents effectively say that it is reasonable for the trier of fact, i.e., the Commission, to infer that rates have been, and are, just and reasonable. In other words, the proponents have proffered a permissive evidentiary presumption that rates are just and reasonable. (In law, where a thing is shown to exist, its continuance is presumed until the contrary is shown or a conflicting presumption arises. See, In re Chicago & N.w. Ry.Co., 138 F2d 753 (1943)).

An evidentiary or permissive presumption is not evidence but a rule of law concerning the handling of evidence; that places on an adverse party the duty of going forward with evidence. Chidichimo v. Industrial Commission, 662 N.E. 2d 611. (1st Dist.

1996). Typically, a party producing evidence to rebut a presumption must come forward with evidence to support a finding of the nonexistence of the presumed fact. See, People ex rel. Daley v. $9,403 In U.S.C., 476 NE2d 80 (affirming trial court's finding that opponents' evidence was not credible, and hence, did not rebut the presumption). Once attacked by the introduction of contrary evidence, the question whether the presumption has been overcome is one for the court. In re Marriage of Smith, 638 N.E. 2d 384, 388 (4th Dist.1994). If the opponent of a presumption offers "positive and uncontroverted" evidence to the contrary, the presumption disappears and the case is in the trier of fact's hands free from any rule. Chidichimo at 615-16. This is also the case when a court is faced with inconsistent or conflicting presumptions. Wesselhoft V. Wesselhoft, 591 N.E. 2d 928 (3rd Dist. 1992) The trier of fact must now weigh the evidence and consider any and all reasonable inferences that can be drawn from the facts. (An "inference" is a process of reasoning by which a fact or proposition sought to be established is deduced as a logical consequence from other facts, or a state of facts, already proved or admitted. Black's Law Dictionary, Fifth Edition at 700).

Thus, in the present situation, to the extent that any party produced relevant evidence that tended to refute any of the basic facts that support the presumed fact (i.e., showing rate increases instead of decreases) or tended to refute the presumed fact that rates are just and reasonable, the trier of fact might well consider the presumption or proffered inference to be less likely.

2. The CUB/AG Complaint

On record for this case, the GCI/City attempted to disprove the presumed fact or inference suggested by AI and Staff although they did so in the form of a new and different proposition. As per the allegations of the CUB/AG complaint (on which these parties shouldered the burden of proof, not just the burden of going forward), the level of the Company's earnings show that rates are not just and reasonable and, thus, need to be reduced.

The basic facts in support of their proposition are as follows:

1. at the outset of the Plan, the Commission's Order established a revenue requirement and going-in rate levels for the Plan based on an authorized return on equity of 11.36% and an overall return on rate base of 9.64%.

2. a revenue analysis performed by witness Smith shows that the Company is earning a 43.18% return on equity for intrastate operations and a 28.55 % return on intrastate rate base.

3. AI is currently receiving excessive, unreasonable and unjust revenues that exceed its authorized rate of return by over $960 million.

On the basis of these facts and showings, CUB and the AG would have the Commission infer that rates (for both competitive and noncompetitive services) are not just and reasonable and thus require reduction, i.e., reinitialization, in going forward.

It is well recognized by both the law and common sense that all of the evidence that either supports or disputes the proposition at hand must be relevant. To be relevant, the evidence must have the tendency to prove or disprove the proposition advanced, i.e., to make the existence of a material fact more or less probable than it would be without such evidence.

Here, the facts alleged and shown under the CUB/AG complaint, even if true and unrebutted, are irrelevant to the issue at hand. Indeed, the evidence proffered by the City/GCI to show that company earnings on all services are higher in 1999 than authorized in 1994, has no bearing on the question of just and reasonable rates in the context and the universe of the Plan which, under Section 13-506.1 only governs "noncompetitive" service rates. While CUB and the AG may not want to draw any lines between competitive and noncompetitive services, the law plainly does. Moreover, given the GCI/City attempt to have earnings on competitive services come into play, despite the language of Section 13-506.1 and the terms of the Plan, it can reasonably be presumed (a negative inference may be drawn) that if they were only to focus on earnings relative to noncompetitive services – they gain nothing from the process. See, Chidichino v. Industrial Commission, 662 N.E. 2d 611 (1st Dist. 1996) (the failure to produce important witnesses or documents indicated a consciousness that the fact or cause is bad or weak.

As such, the proffered evidence in support of the CUB/AG complaint does not refute the presumption set out by AI and Staff. Nor does it establish a reasonable proposition or presumption for resolving the main question, i.e., just and reasonable rates for noncompetitive services under the plan.

The pleading set forth by CUB and the AG was, essentially, a misguided attempt to reconcile the Company's overall earnings (at one point some 5 years after the Plan's continuing operation) by looking to the "baseline" for the Plan at its implementation stage. Yet, once that baseline was established and settled the initial overall rates, it effectively dissolved. Thereafter, only noncompetitive rates evolving under the price index and possibly the earnings thereon were open to consideration and challenge under Section 13-506.1. As such, there is no real nexus between the theory and broad sweep of the complaint (and evidence thereon) and the pending plan review proceeding. The complaint was not well pled as either an attack on the Staff and AI suggested presumption/inference or as an independent action regarding rates on which CUB and the AG shoulder the burden of proof.

Notably too, the Appellate Court's review of Section 13-506.1 settled the legal question of earnings as a measure of just and reasonable rates once and for all by its flat rejection of CUB 's arguments on that very issue. Further, the end result of accepting the GCI/City's proposition would be to require a rate reduction across the

board – not just noncompetitive services without due consideration of other provisions in the Act that focus on, and govern, competitive services. (See, for example, the difference in issues and parties shouldering the burden of proof in Section 13-506.1 vs. Section 13-505) This would be contrary to legislative intent as well as outside the scope of this proceeding. On all these counts, reinitialization would put the Commission outside of the law.

That portion of the Appellate Court's slip opinion (unpublished per Rule 23) on which CUB relied in its oral argument, does not help its position.

The Court recognized that the Alt Reg Order, in effect, set out a permissive presumption, which it considered as "merely cautioning parties contemplating a rate challenge that the Commission will dispose of frivolous complaints in a summary matter." The Court further explained that "to say that rates filed pursuant to the plan are just and reasonable, is merely another way of saying that the petitioner who challenges such rates bears the burden of proof. (Id.).

To be sure, CUB and the AG had the absolute right to file a complaint and have it be considered "in the context of this case." Section 13-506.1(e) expressly authorizes the bringing of a complaint but – by its very terms and the title of the statute – only noncompetitive rates are put at issue. The statute further assigns the burden of proof to the Complainant. That burden must be met by a relevant and material showing. It has not been satisfied in this case and the record would have the Commission so find.

Cautionary Note:

On a cautionary note, sometimes, as is the case here, evidence relevant for one purpose or to support one proposition may be irrelevant for another purpose or a different proposition. In such situations, there is always the danger of unfair prejudice. Whereas the earnings analysis in this case might be established as relevant to the issue of earnings sharing - if this particular form of alternative regulation were shown to be viable - it is both irrelevant and highly prejudicial to the just and reasonable rates proposition and the reinitialization of rates proposal. The Commission must not be swayed by the emotional arguments and the figures casually tossed about when it is deliberating on the issue of just and reasonable rates.

B. Further Evidentiary Support for the AI and Staff Propositions

The burden of persuasion remains with the party who initially has the benefit of the presumption, i.e., that rates are just and reasonable. Here, in addition to setting out the facts for the proposition discussed above, both AI and Staff went further by presenting certain other analyses in support of their position that noncompetitive rates are just and reasonable.

Ameritech Illinois Evidence

Ameritech provided a series of external benchmark support (tests) for the Commission's consideration. The suggested inference that rates are just and reasonable became more compelling in light of this additional evidence.

Test I

Mr. Gebhardt directly addressed whether AI's noncompetitive services became "more affordable" compared to other goods and services purchased by consumers. (AI Ex. 1.1 at 13) His testimony includes a chart that compares the price changes for AI's services to the Consumer Price Index (the 'CPI") which he asserts to be the most widely accepted measure of price changes for consumer goods.

This chart –1, indicates that the prices for AI's noncompetitive services have fallen dramatically relative to other products and services. Further, Gebhardt maintains that consumer purchasing power increased over this period as measured by the Bureau of Economic Analysis. (Id.)

Thus, Gebhardt contends, AI's noncompetitive service rates are more affordable today than they were in 1994 – and even then, they were among the lowest in the country. According to Gebhardt's testimony, affordability is a concept expressed in Section 13-103 of the Act. 220 ILCS 5/13-103 (a) and (d) (vii). More than once, we would note, the Appellate Court has referred to "affordability" several times when discussing rates under alternative regulation. (Illinois Bell, 669 N.E. 2d 925, 929, 930).

Test II

According to Gebhardt, another way to assess "affordability" is to compare the overall price of AI's noncompetitive telecommunications services to both changes in the consumer price index ("CPI") and to changes in wage levels over the 1994-1999 period. In his testimony, Gebhardt presented yet another chart titled "Comparison of PCI and ECI," which when combined with the previous chart –1 above, showed prices for AI's residential services to have fallen relative to both the CPI and wages. (AI Ex. 1.1 at 72-73).

Test III

Another approach put forward by AI, is to compare AI's rates with those of other incumbent LECs. According to Gebhardt, based on FCC studies, AI's local residence rates are 34% lower than the weighted average of residence rates for 86 cities. Its rates are also lower than those of the other major independent phone companies in Illinois. Gebhardt's Schedule 5 shows these rate comparisons. (AI Ex. 1.1 at 74, Schedule 5).

Test IV

Still another approach taken by AI, is to compare certain of its key rates to the corresponding filed rates of AT&T, MCI, McLeod and USXchange for local service. Schedule 6 to Gebhardt's testimony provides such a comparison, and shows AI's rates to be comparable to those of the direct competitors mentioned.

Whereas new entrants typically engage in promotional behavior to attract customers, Gebhardt pointed out that competitor rates are still within a reasonable range of AI's, thus showing the Company's rate to be in line with the underlying cost structure of the industry (even as against companies entering with new technologies and lower overhead). (AI Ex. 1.1 at 75).

C. Earnings Model for Alternative Regulation

Whereas the Appellate Court settled the question of earnings as not being the prominent indicator of just and reasonable rates, earnings may be one factor of many to be considered in reviewing an alternative regulation plan. But, we agree with Gebhardt's contentions that the traditional old world earnings model would have to be modified in order to meet the statutory parameters of Section 13-506.1.

1. AI Methodology

To be sure, a traditional rate case analysis includes a carrier's earnings on all regulated services, both competitive and noncompetitive. Section 13-506.1, on the other hand, only applies to and governs noncompetitive services. By law, therefore, any earnings analysis or review is strictly limited to earnings on noncompetitive services only.

Gebhardt attempted just such an analysis, reflected in Schedule 7 of his supplemental direct testimony, i.e., AI Ex. 1.1.

To be sure, neither Staff nor Dr. Selwyn support Gebhardt's approach. Essentially, they maintain that it is not an accepted or recognized methodology. They also do not propose any alternative type of methodology. The inability to devise an agreed-upon process, however, does not mean that one can outright ignore the elements and requirements of a statute, i.e., Section 13-506.1.

2. Staff's Zone of Reasonableness Test

Noting at the outset that the evaluation of a alternative regulation plan must focus on the rates produced thereunder, Staff nevertheless believes that earnings generated under a plan may be relevant in certain circumstances although not in the circumstances of this case.

According to Staff, earnings that fall within certain parameters or boundaries - arrived at by reasoned and informed judgment – do not reflect adversely on the justness or reasonableness of noncompetitive service rates. It is only when earnings are either short of or beyond a particular zone of reasonableness, that some concerns are raised. According to Staff, the zone is defined by certain boundaries:

Upper boundary of the zone – earnings cap at levels reflecting enhanced cost effectiveness, and technical and market progressiveness (and would surely include or factor in, the prevailing economic climate). Only if earnings peak above this boundary, would Staff consider there to be signals of some oddity or peculiarity with the Plan's operations e.g. misspecification of Plan parameters, or misapplication of the Plan.

Lower boundary of the zone – considerations of the financial integrity of the company and its attendant ability to deliver appropriate levels of service availability and quality come into focus. Once below this boundary, there is a need for Commission action.

Applying the zone of reasonableness test to the instant case, Staff concluded that the Company's noncompetitive service rates and related earnings are not outside the zone of reasonableness.

D. The Evidence as a Whole

At the time this review proceeding commenced, there was no settled standard by which to positively, conclusively, and quantitatively establish that rates are just and reasonable under an alternative regulation plan. While the law itself does not provide an express test - it does speak of "affordability" and the Appellate Court also refers to "affordability" time and again in its opinion. (See Illinois Bell Telephone Company v. Illinois Commerce Commission, 669 N.E. 2d 925, 929, 930).

The thought arises and the natural impulse may be to compare the results of the plan in each of its years of operation against the results of having continued the Company under traditional ROR regulation. This would constitute, in our view, the "perfect and parallel world" test.

The record shows a test of this kind to be highly impractical if not impossible. As Dr. Harris points out, no one can redo history. (AI Ex. 4.2 at 11). There is no simple way to wind back the clock and determine both, in terms of the company and its customers, what would have happened if AI had remained under ROR regulation. According to Harris, computing what "would have occurred" under ROR during the 1995-1999 time period, is more than just a spreadsheet exercise; it would require a re-determination of the many decisions made if managers were faced with rate of return incentives instead of market-based incentives at each and every step.

Harris further contends that any attempt to isolate one variable (rates) and leave untouched or unconsidered all of the many other variables is meaningless as an

economic matter. Mr. Gebhardt also noted the inappropriateness of looking at data for only a single year of the plan. According to Gebhardt, earnings over the entire review period, if at all, are essential to a proper earnings review.

GCI witness Terkeurst herself admitted that it may not be possible to establish what the precise outcome of continued ROR regulation would have been, (GCI Ex. 11.0). Dr. Selwyn proposed that the justness and reasonableness of AI's rates could be judged by a comparison to the rates of its competitors, but absent that, the other means available would be an evaluation of the company's earnings. According to Staff, the very idea that it is possible to compare the results of alternative regulation against what would be the outcome had AI stayed under ROR regulation, is wrong. Such a process, witness Hoagg testified, entails much more than just looking at rates and earnings.

Notably, there is no indication in the 1994 Order that we can find to require a reinitialization of rates as part of this review (which the Commission carefully circumscribed). Nor did the Commission require a general rate case as the test of just and reasonable rates under the Plan.

The record on the whole shows that looking to ROR regulation for plan review purpose is both unrealistic and inappropriate. Just as there is the concept of integrity in the law, there must be integrity inherent in an evaluative methodology. A comparison against rate of return regulation for each year of the plan's operation is simply impossible and would involve speculation upon speculation, a process in which the Commission does not itself engage. (See, e.g. record disputes speculating at what time a rate case would have taken place in a ROR regulation scenario). At is very core such a comparison is an illogical mix of apples and oranges. So too, a one-year overall earnings analysis is even more contrary and reflects nothing meaningful to the issue at hand.

On balance, the various test propositions of AI (and, on some level, Staff's zone of reasonableness test) have merit in that they focus on the correct universe, i.e., noncompetitive service rates (and related earnings), governed by the Plan and address themselves directly to the concept of "affordability" expressed by both the law and the courts.

It not individually, then certainly cumulatively, these test propositions and the analyses thereunder, have merit in establishing that noncompetitive rates under the Plan are just and reasonable. They support the inference suggested by AI and Staff (discussed above) and compel a finding of just and reasonable rates. This is what the PEPO concludes.

VIII. Balancing of Interests between Ratepayers and Shareholders (Traditional) v. Ratepayer Benefit/Public Interest under Section 13-506.1 (b)(5) (New).

A running theme throughout most of the Intervenor oral arguments is their assertion that the Commission must balance ratepayer and shareholder interests. (e.g., Tr. 2339, 2354, 2358). At no time in their arguments, however, do they discuss or explain the particulars or application of this proposition. It is apparent from the written arguments in their brief that the GCI parties only equate benefits with earnings as under ROR regulation. (See PEPO at 196). Indeed, it has been argued, that the Commission expected overall earnings (not just rates) to remain just and reasonable. (Tr. 2345).

There are fundamental differences between ROR regulation and alternative regulation - which these parties either fail or refuse to comprehend. One of these, but perhaps the least obvious, is the language itself. Alternative regulation has its own terminology under both the statute and the Alt Reg Order (e.g., "annual filings", "price index"). It is wholly and far different from the terminology of ROR regulation (e.g." test year"). When ROR regulation made its way to the courts, the "balancing" concept arose from an altogether different set of interests than what the Commission considers here today or what the Appellate Court considered in its review of the Alt Reg Order and Section 13-506.1. Illinois Bell Telephone Company v. Illinois Commerce Commission, 669 N.E. 2d 919 (2nd Dist. 1996). Hence, it is not viable in these premises.

Alternative regulation, both by its terms and in practice, speaks to entirely different set of benefits or interests as found in Section 13-506.1's requirement that the plan:

> specifically identifies how ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change, and improvements in productivity due to technological change. 220 ILCS 5/13-506.1 (b)(5);and,
> that it is in the public interest. 220 ILCS 5/13-506.1 (b) (1).

With respect to such requirement, the testimony of record shows that, due to the Plan, direct customer benefits began in 1994 with the $93 million rate decrease that the Commission ordered and thereafter, customers benefited from yearly rate reductions as a result of the application of the price index. According to Gebhardt, for the first year, i.e., 1995, the rate reduction alone was $39.8 million. So too, he states, the cumulative annual rate reductions over the entire period were $301 million. The total benefit from both the initial and subsequent rate reduction was $943 through the end of 1999.

Note: Oral arguments by AI indicate that this may not be the correct total amount; the Commission might call on AI and/or Staff to check the actual figures. (Tr. 2451).

What is most notable is that, under the plan, customers have seen rate reductions in each of the years of operation. This is a significant benefit over what ROR regulation offered. Rate reductions, if they occurred as the result of a rate case,

occurred less frequently and reached a different population of ratepayers. Another benefit or objective for the Plan, was to protect customers from the downside impact of changes in demand for AI's services be it as a result of head on competition from other carriers, technological changes or other reasons.

Both the record and experience show that technological changes have indeed shaken the industry. The recent explosion in wireless, data traffic and internet use by both residential and business customers created new telecommunications markets, with many more and diverse types of providers and new services. Customers' expectations were and are being raised.

A good example of the changes in technology to which AI must respond is provided in newly enacted Section 13-712 where the General Assembly has provided for use of alternative telephone service in certain instances, and expressly defined "alternative telephone service" to mean, in part:

> a wireless telephone capable of making local calls, and may also include, but is not limited to, call forwarding, voice mail, or paging services. 220 ILCS 5/13-712 (b). (Emphasis added).

The showings of record must be viewed as a whole. As the PEPO observes at page 68, a significant number of benefits were realized under the plan. These include: the rate reduction discussed above; investment in network; millions spent to facilitate competitors' entry; readying the company for competition with a new business oriented mindset; and, given the freedom to manage its capital recovery shortfall, the Company addressed the problem with no impact on rates. Such are the material and realized benefits of an alternative regulation and the instant plan. These are vastly different from, and have no viable counterpart in traditional regulation. Thus, the balancing argument put forward by the GCI Intervenors, but unexplained in relationship to the plan, has no relevance to this matter.

IX. Reporting Requirements

On the basis of the oral arguments, we believe that the reporting requirements for the Plan may need to be revisited here in order to make reporting responsive to the realities of the Plan for any future reviews. Time and again, the Intervenor arguments point to the Commission required earnings reporting as bearing directly on the issues of this review proceeding. (Tr. 2349, 2357).

In the section of the 1994 Alt Reg Order titled Annual Reporting, there is discussion of the parties' positions. In adopting a modified version of Staff's reporting requirements, the Commission noted that:

> …to the extent Dr. Selwyn's recommendations focus on competitive services, the Commission is not persuaded that

> requiring the additional information is demonstrably cost-beneficial in conjunction with the adoption herein of the alternative regulatory framework for non-competitive services. (Alt Reg Order at 92)

The Commission further wrote:

> We also reject Illinois Bell's argument that the adoption of price regulation without earnings sharing eliminates the need for reporting of the financial information identified by Staff. Although rate of return no longer will be the focus of regulatory control for the duration of this alternative regulatory plan, the data still may provide useful evaluative information. For example, unusually high reported rates of return, particularly in the face of accelerated depreciation charges, may constitute a possible early warning that the total offset in the price regulation formula has been set too low or that pricing constraints have been otherwise ineffective. In addition, rate of return information may provide insights into various social subsidy issues which are likely to arise in the future. (Alt Reg Order at 92).

Presumably too, the Commission required earnings reporting in the event that the earnings sharing form of alternative regulation would be advanced in a future proceeding. (See Alt Reg Order at 51). Ms. Terkeurst's testimony notes that the Commission required AI to submit "overall earnings information with each of its filings and as part of this review proceeding. She testified that without such analyses of the Company's overall earnings, it would be impossible to evaluate evidence and arguments in support of, or in opposition to, an earnings sharing proposal.

In testimony for this case, Gebhardt's notes that Commission requirements 1-6 as set out in the Alt Reg Order are generally directed towards financial information which permits the Commission to determine the Company's earnings levels (e.g., rate base, revenues and expenses, capital structure and return on investment). (Ex. 1.0 at 10-11). According to Gebhardt, the Company objected to these reporting requirements in Docket 92-0448 on the grounds that they were inappropriate in an alt reg plan and it restates that position here. Simply put, Gebhardt maintains, it is fundamentally inconsistent with the policies underlying price regulation to continue monitoring earnings as if the company remains under rate-of-return regulation.

Mr. Gebhardt states a valid point. Under Section 13-506.1 (d), reporting to the Commission is intended to "document that the requirements of the Plan are being properly implemented." 220 ILCS 5/13-506.1. Nothing more and nothing less is required. To the extent that the Plan, as modified, would contain no earnings sharing component, reporting "overall" earnings is both unnecessary and inappropriate within the context of the plan (which governs only noncompetitive services and related

earnings). This is not to say that the Commission cannot keep itself informed on overall earnings as a general matter, only that overall earnings should be established as inappropriate to any future plan reviews.

Moreover, we believe Gebhardt's testimony provides an explanation for the divergent path that the evidence took in this matter. To be sure, the complaint action filed by CUB and the AG focused exclusively on earnings as a test of just and reasonable rates. So too, on oral argument, the certain of the Interveners refer to AI's "reports" to the Commission as authority for bringing earnings into issue at this review proceeding. (Tr. 2357). This raises our belief that reporting should be modified. Indeed, if the Commission is inclined to review earnings under the Plan, we propose that Staff work together with AI in an attempt to formulate an appropriate means by which to assess earnings on noncompetititve services

X. Commissioner Questions/Comments (January 29, 2002 session)

A. Commissioner Harvill - Re: the PEPO's failure to sufficiently discuss the alternative of ROR regulation.

Our discussion of ROR was limited because it seems clear that the General Assembly favors alternative regulation for noncompetitive services. Indeed, it goes so far as to permit the Commission, on its own motion, to initiate the consideration of an alt reg plan.

The record indicates that ROR regulation dates back at least 70 years and was developed in the era of monopoly supply of utility services and slow moving changes in technology. (Gebhardt, AI Ex. 1.1). So too, appears that ROR is revered only because of its long- term use and general effectiveness – not because it is a perfect model or because it produced perfect results. The benefits arising under a plan, as shown in this review, are more substantial and pronounced. For example, due to the Plan, customers have seen rate reductions each year of its operations. On balance, rates reductions – if they occur under ROR regulation - would only result from a time and resource consuming rate case proceeding and with much less frequency.

The fact that the regulatory arena is changed is evidenced by the fact that there are, by statute, both competitive and noncompetitive services. And, there are also provisions in the Act that address each individually as well as cumulatively. There are also provisions in the recent amendments that only pertain to carriers operating under an alternative regulation plan. At present this would only be Ameritech Illinois. All of this shows that for Illinois, as is the case in a large number of other jurisdictions, alternative regulation is more appropriate.

The record testimony outlined a number of the deficiencies of ROR. Among them were the following:

- fails to provide adequate incentives for companies to operate efficiently or make any risky investments,

- subjects customers to downside risks of competition (potential for declining revenues and stranded or underutilized investments); Under ROR customers have the legal obligation to guarantee AI a reasonable profit.

- the traditional regulatory process incents the company to defer capital recovery on long-level investments for as long as possible because – in short runs - higher depreciation rates directly translate into higher customer rates.

It may well be presumed that the General Assembly was itself aware of these deficiencies when it initially enacted Section 13-506.1 and it changed nothing by its most recent activity.

We further believe that a return to ROR regulation is only possible on a finding that the Plan is shown to have failed. The evidence of record does not support such a finding. Assuming arguendo, there was such a demonstration, a separate rescission action is necessary. See Quantum Pipeline v. Illinois Commerce Commission, 709 N.E.2d 950 (3rd Dist. 1999). (When exercising its power to rescind, the Commission is required to provide notice by means of a written complaint setting forth an alleged violation of the Act, order or rule of the Commission, and setting a time and place for the hearing thereon).

B. Commissioner Kretschmer: Re – alternative regulation in other jurisdictions.

According to the NRRI/NARUC study, the move to incentive regulation has steadily increased over the past decade. Table I, set out in the rebuttal testimony of Dr. Harris at page 7, shows that 4 states adopted price cap regulation in 1994 while 37 states had adopted price cap regulation by year 1999. (Harris, AI Ex. 4.2 at 6,7)

In addition, other record testimony shows that in Oregon, the state commission, unsatisfied with service quality, moved US West back under ROR in 1997. In 1999, however, the Oregon legislature changed its statute such that US West is now again under price regulation.

This completes our memo. The ALJs remain available to answer any questions the Commission might have on the issues of the case.

APPENDIX A

§220 ILCS 5/9-241. Discrimination; prohibition

No public utility shall, as to rates or other charges, services, facilities or in other respect, make or grant any preference or advantage to any corporation or person or subject any corporation or person to any prejudice or disadvantage. No public utility shall establish or maintain any unreasonable difference as to rates or other charges, services, facilities, or in any other respect, either as between localities or as between classes of service.

However, nothing in this Section shall be construed as limiting the authority of the Commission to permit the establishment of economic development rates as incentives to economic development either in enterprise zones as designated by the State of Illinois or in other areas of a utility's service area. Such rates should be available to existing businesses which demonstrate an increase to existing load as well as new businesses which create new load for a utility so as to create a more balanced utilization of generating capacity. The Commission shall ensure that such rates are established at a level which provides a net benefit to customers within a public utility's service area.

Prior to October 1, 1989, no public utility providing electrical or gas service shall consider the use of solar or other nonconventional renewable sources of energy by a customer as a basis for establishing higher rates or charges for any service or commodity sold to such customer; nor shall a public utility subject any customer utilizing such energy source or sources to any other prejudice or disadvantage on account of such use. No public utility shall without the consent of the Commission, charge or receive any greater compensation in the aggregate for a lesser commodity, product, or service than for a greater commodity, product or service of like character.

The Commission, in order to expedite the determination of rate questions, or to avoid unnecessary and unreasonable expense, or to avoid unjust or unreasonable discrimination between classes of customers, or, whenever in the judgment of the Commission public interest so requires, may, for rate making and accounting purposes, or either of them, consider one or more municipalities either with or without the adjacent or intervening rural territory as a regional unit where the same public utility serves such region under substantially similar conditions, and may within such region prescribe uniform rates for consumers or patrons of the same class.

Any public utility, with the consent and approval of the Commission, may as a basis for the determination of the charges made by it classify its service according to the amount used, the time when used, the purpose for which used, and other relevant factors.

§ 220 ILCS 5/9-250 Rates, charges or regulations found to be unjust, redetermination by Commission

Whenever the Commission, after a hearing had upon its own motion or upon complaint, shall find that the rates or other charges, or classifications, or any of them, demanded, observed, charged or collected by any public utility for any service or product or commodity, or in connection therewith, or that the rules, regulations, contracts, or practices or any of them, affecting such rates or other charges, or classifications, or any of them, are unjust, unreasonable, discriminatory or preferential, or in any way in violation of any provisions of law, or that such rates or other charges or classifications are insufficient, the Commission shall determine the just, reasonable or sufficient rates or other charges, classifications, rules, regulations, contracts or practices to be thereafter observed and in force, and shall fix the same by order as hereinafter provided.

The Commission shall have power, upon a hearing, had upon its own motion or upon complaint, to investigate a single rate or other charge, classification, rule, regulation, contract or practice, or any number thereof, or the entire schedule or schedules of rates or other charges, classifications, rules, regulations, contracts and practices, or any thereof of any public utility, and to establish new rates or other charges, classifications, rules, regulations, contracts or practices or schedule or schedules, in lieu thereof.

§220 ILCS 5/13-505.2 ---Nondiscrimination in the provision of noncompetitive services.

A telecommunications carrier that offers both noncompetitive and competitive services shall offer the noncompetitive services under the same rates, terms, and conditions without unreasonable discrimination to all persons, including all telecommunications carriers and competitors. A telecommunications carrier that offers a noncompetitive service together with any optional feature or functionality shall offer the noncompetitive service together with each optional feature or functionality under the same rates, terms, and conditions without unreasonable discrimination to all persons, including all telecommunications carriers and competitors.

EM/PAC:jt